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РАЗШИРЯВАНЕ ОБХВАТА НА БАНКОВИЯ НАДЗОР

Мирослав Неделчев

EXTENSION OF THE SCOPE OF BANKING SUPERVISION

Miroslav Nedelchev[49]

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Abstract

The aim of the paper is to present the dynamics in banking supervision. Adapting banking supervision to the new reality is justified by protecting stakeholders and preventing future crises. To a large extent, the financial crisis is due to the limitation of banking supervision on the observance of financial ratios only.

The results of the paper present the new banking supervision functions. The scope of supervision is extended to non-financial information related to the internal governance of banks. The process of supervisory restructuring leads to a new process - the modernization of the banking system.

Keywords: *corporate governance, restructuring and modernization, non-financial issues*
JEL Codes: *G28, G34*

Introduction

In the new reality, the supervisory practices are adapting to market circumstances (Houbenova-Delisivkova, 2015). The construction of complex banking structures and the provision of innovative services are ahead of adaptation of supervisory practices (Kazandjieva-Yordanova, 2017). The trend towards cross-border banking poses a critical rethink of the existing supervisory framework, based on joint responsibility between national authorities from home and host countries (Sariiski, 2010). Regardless of the degree of convergence of supervisory practices and joint solutions, there are still differences in supervisory methodologies, results and costs. The interests of the stakeholders, incl. of taxpayers, are placed before those of shareholders and banks.

The dynamics in the banking system generates an adaptation of supervisory policy. This process is an administrative reaction to the cross-border activity of the banking

[49] Economic Research Institute, Bulgarian Academy of Sciences, mknedelchev@abv.bg

groups. The measures in the EU to address the effects of the global financial crisis concern supervisors and banking groups in the euro area only. In the new reality, banking supervision shifts from a „soft laws“ based on recommended norms (national codes of good practice) toward a „hard“ legislation that applies to euro area banks with public company status only.

The high dynamics in adapting supervision to changes in the banks determine the innovation of our topic. Consistent with the supervision trends in the new reality, we formulated the following research hypotheses:

H1: The introduction of complex structures and services in the banks leads to an increase in the number and functions of banking supervision;

H2: The new scope of banking supervision covers non-financial information and includes corporate governance practices.

The structure of this paper consists of three parts. In the first part we present the banking supervision in the new reality – as both source and way out for global financial crisis; in second part we discuss the dynamics of banking supervision in the euro area; the last part includes extension of banking supervision scope to non-financial information.

1. Banking supervision in the new reality

The main source for the global financial crisis is banking supervision (Sun et al., 2011). The last researches record 100 systemic crises for the past 50 years due to shortcomings in banking supervision (Barth et al., 2013). Similar to previous crises in the current crisis, the banking supervision turns out to be a critical factor for the banking system, regardless of the measures taken (European Commission, 2013).

Measures to mitigation of the effects of global financial crisis include increased volume and complexity of banking supervision requirements (European Banking Authority, 2016a). For the scale of banking supervision's reforms can obtain an idea through the amount of supervisory measures adopted - averaging around 200 per day worldwide, as well as penalties for a total of USD345 billion for the period 2009- 2017 (Boston Consulting Group, 2018).

In most cases, supervisory measures are aimed at changing business models and good corporate governance practices that, taken together, constitute a reform to reduce the likelihood of bank crises and minimize the social costs that may arise in the future:

- the supervisor authorities regard corporate governance as a key element of a sound functioning and a reduction in the risk profile of a bank (Basel Committee on Banking Supervision, 2010);

- reducing taxpayers' costs for restructuring a problem bank without jeopardizing financial stability (Directive 2014/59/EC). For this purpose, losses are taken over by the

shareholders and creditors of the troubled bank and they have incentives to monitor the bank's position.

In the new reality, banking supervision should be seen both as a source and as a way out of the global financial crisis.

One of the sources of the crisis is the inadequate supervision that led to imprudent risk-taking (European Securities and Markets Authority, European Banking Authority, 2017). The lowered control of good practices under the „comply or explain“ approach has reduced control by shareholders in making decisions, preventing shareholders from exercising their voting rights and lead to excessive remuneration for seniors (European Council, 2017).

As a major outcome of the financial crisis, the division of responsibilities between the supervisors of the home and host countries is constituted. The EU supervision measures have been implemented by returning to „hard“ legislation. The lessons from the global financial crisis have led to a long-term stakeholder engagement and improved financial stability practices (Financial Stability Board, 2017).

2. Dynamics of banking supervision in the euro area

A Single Supervision Mechanism for all euro area banks (around 5,000 banks) was introduced by the end of 2014. The competent authorities for supervision are the European Central Bank and national authorities. The way in which prudential supervision in the euro area is applied has changed substantially. The new moments are related to the coordination, convergence and harmonization of supervisory practices in the euro area. It can be argued that is emergence of a new supervisory culture.

Similar to the structure of cross-border groups, the structure of banking supervision in the euro area is changed. Supervisory sovereignty is delegated to pan-European authorities. The dynamics are related to the creation of new supervisory authorities and the introduction of new supervisory functions:

- The European Central Bank is a direct supervision authority for systemically significant banks in the euro area (119 banks, representing 82% of euro area banking assets) and banks requesting direct public financial assistance from the European Stability Mechanism (European Central Bank, 2017). The ECB's monetary and supervisory functions are divided. For the supervision of any significant supervised person, a joint supervisory team of European Central Bank staff and the national supervisor under the coordination of a specific European Central Bank employee shall be established. Any European Central Bank supervision procedure shall be initiated ex officio or at the request of a euro area Member State.

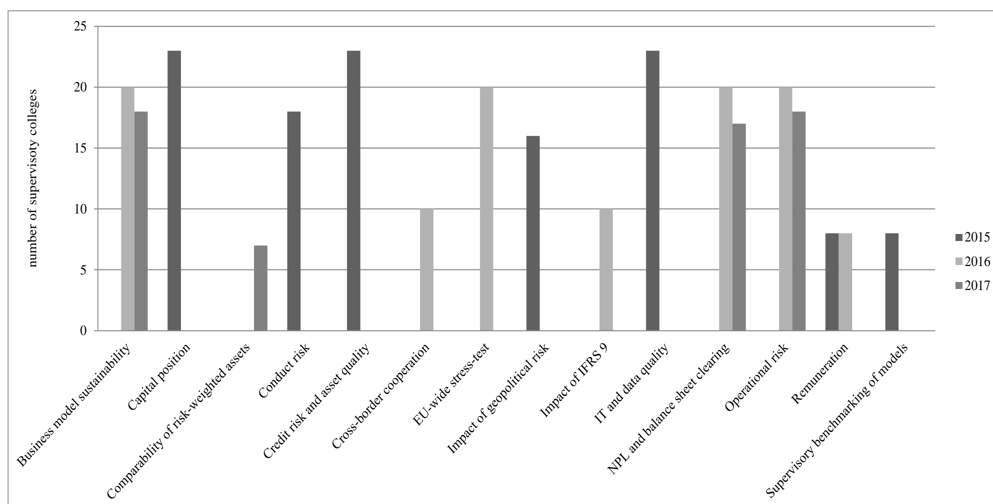
- National authorities supervise rest banks that are outside the scope of the European Central Bank. The competent authorities retain their powers vis-à-vis banks

that are systemically important to the national economy, taking into account the secondary effects on other Member States. The European Central Bank, together with national authorities, put in place uniform standards for supervision of less important banks. The competent national authorities retain the obligation of accountability to national parliaments under local law. The national competent authorities shall assist the European Central Bank in the performance of its tasks.

- The European Banking Authority acts as a mediator to reach agreement between national supervisors and has the function of convergence the national supervisory practices. The European Banking Authority is the consolidating supervisor for euro area banks.

- Supervisory colleges are permanent structures consisting of the home and host supervisors of cross-border banks. The main task of the supervisory colleges is to elaborate rules for the functioning of a banking group, taking into account the specifics of structure and risk profile according to the individual national legislations. In the case of a systemically important bank, the chairmanship of a supervisory college is legally defined for the European Central Bank. The activities of supervisory colleges are in line with the guidelines developed by the European Banking Authority. In the last reporting years, the data of the European Banking Authority reflects the trend of expanding the scope of supervisory colleges to non-financial activity and corporate governance of banks (see Figure 1).

Figure 1. Topics discussed by supervisory colleges



Source: European Banking Authority, 2016b; European Banking Authority, 2017a

3. Extending the scope of banking supervision to non-financial information

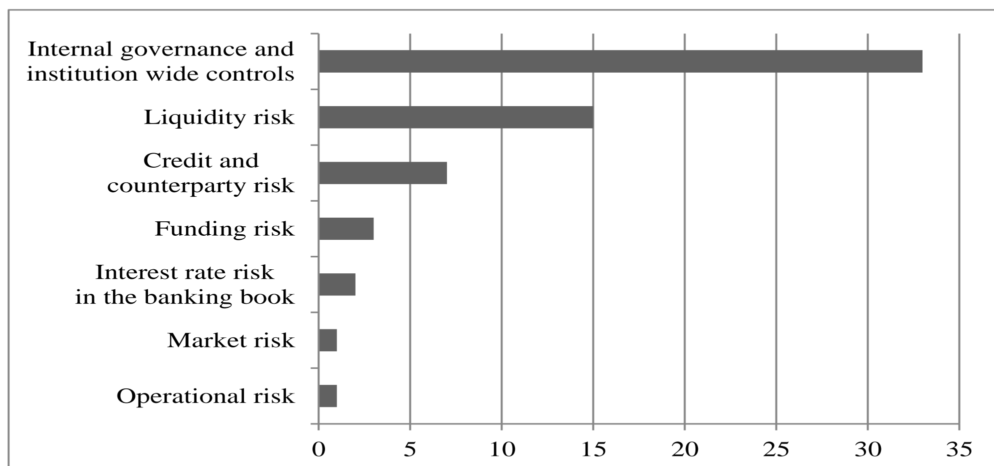
Traditionally, banking supervision is confined to preventive measures for compliance of financial ratios. Regardless of the compliance with European and international financial ratios, the global financial crisis has shown the need to extend the scope of supervision. According to Directive 2013/36/EC, the shortcomings that have led to systemic problems are the unclear role of competent authorities in supervising corporate governance systems and insufficient supervision over the effectiveness of internal governance procedures.

The unclear role of competent authorities in supervising corporate governance systems for banks did not allow sufficient supervision of the effectiveness of internal governance procedures. The global financial crisis has highlighted deficiencies in supervision and the need to expand it functions.

Failure to comply with good corporate governance practices is the most common violation for supervisors. Good corporate governance practices include, above all, requirements for the reliability and suitability of management bodies. Most supervisory sanctions are imposed for violations of corporate governance, including internal control mechanisms, management functions and remuneration policies for seniors (European Central Bank, 2017).

A total of 62 control measures were imposed by different competent authorities in 2016. A significant number of these measures (33) concern corporate governance (see Figure 2).

Figure 2. Scope of implemented supervisory measures, 2016



Source: European Banking Authority, 2017b

In order to deal with the potentially detrimental impact of poorly developed corporate governance practices for sound risk management, the Member States should put in place principles and standards to ensure effective control by the management bodies, to promote a culture of taking reasonable risks at all levels in banks and to empower the competent authorities to monitor the adequacy of internal governance practices. These principles and standards should be applied taking into account the nature, scale and complexity of the banks' activities. Member States should be able to impose additional principles and standards for corporate governance.

The expanded scope of banking supervision includes:

3.1. Assessing the suitability of shareholders:

Supervisors issue a bank license after a suitability test for shareholders (Directive 2013/36/EC). The purpose of the Directive is to ensure the sound and prudent management of the bank. Shareholders should be able to fulfill their role as a principal in corporate governance. In the event that the bank performs a cross-border activity, prior consultations are held between the competent authorities of the individual countries to determine whether the shareholders are suitable.

3.2. Assessing the suitability of the members of the management body

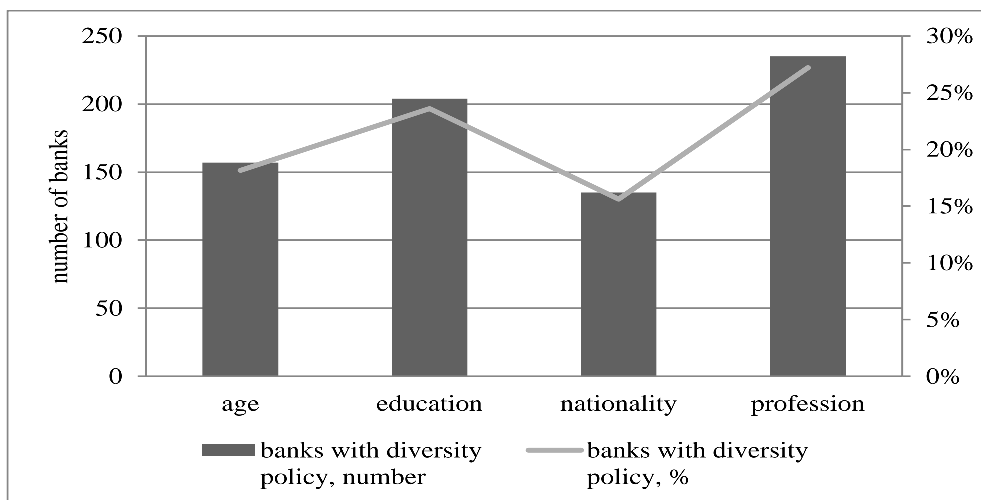
Competent authorities have the authority to grant a banking license if the members of the management body have a good reputation, sufficient knowledge, skills and experience to perform their duties. For this purpose, the supervisory authorities shall conduct a suitability test for the members of the management body. In most cases, the suitability assessment is related to the candidate's time and experience (European Central Bank, 2017). Additional requirements in the fit and proper test are the ability to perform their functions independently, to allocate sufficient time to perform their functions and the self-assessment of the management body with regard to its composition and requirements of collective aptitude. Internal control officers and chief financial officers are also included in the assessment of suitability (European Securities and Markets Authority, European Banking Authority, 2017).

3.3. Diversity of the management body

Competent authorities shall require from banks and relevant nomination committees to include a wide range of qualities and skills when nominating members of the management body. To increase the quality of decisions made and to reduce the likelihood of future crises, a requirement for banks to adopt their own diversity policy for the entire cross-border group is introduced (Nedelchev, 2018). According to the regulations, the diversity of the board has four dimensions: age, education, nationality and profession (see

Figure 3). Competent authorities collect information on diversity and provide it with the European Banking Authority for a subsequent comparison of diversity practices.

Figure 3. Diversity of the management body



Source: European Banking Authority, 2016c

3.4. Determining the remuneration of seniors

In order to protect financial stability, the competent authorities should ensure compliance with policies on the remuneration of seniors. The purpose of remuneration policies is to undertake a reasonable risk and limit the „appetite for risk“ that were considered as leading factors for the global financial crisis.

Competent authorities shall ensure that banks set up their own remuneration committees and that they are responsible for making salary decisions. The decisions of the remuneration committees take into account the long-term interests of shareholders, investors and other stakeholders as well as the public interest.

National authorities aim to increase transparency while the European Banking Authority – to harmonize the remuneration framework. The competent authorities collect the information in accordance with the disclosure criteria and use it to compare the trends and practices in the fields of remuneration. Information is provided to the European Banking Authority, which performs a comparative analysis every year (European Banking Authority, 2016d). The analysis covers over 100 banks and remunerations of over EUR1 million for an individual person. One of the reported results is achievement a match between reward and risk by increasing the percentage of staff ranked as high-paid from 59% in 2013 to 87% in 2014.

3.5. Composition of the management body

The convergence process has led to sharing of the Anglo-Saxon practice of separating the functions of chairman of the board and of chief executive officer (Directive 2013/36/EC). The competent authorities can assess a wider range of key persons. For example, when combining too many directors' positions leads to insufficient monitoring and control time. Therefore, a member of a management body may not simultaneously hold more than one CEO position and two non-executive directorships or four non-executive directorships. In addition, the competent authorities may authorize members of a management body to hold one additional non-executive position (Directive 2017/828).

The result of the constraint on the simultaneous occupation of several positions by one director is entering of new persons in the management and is improved the diversity of the board. A small number of directors (3.98% of executive directors and 5.88% of non-executive directors) exceeded the limit for simultaneous employment (European Securities and Markets Authority, European Banking Authority, 2017).

3.6. Control over external auditors

Supervisors are interested in the quality of external auditors to improve the effectiveness of supervision (Basel Committee on Banking Supervision, 2013). To this end, it is necessary to establish and maintain effective relations with external auditors.

The responsibility for the quality of the external auditor is shared between the banking supervisor and the relevant auditor authority. To this end, there is a regular and effective dialogue between the two supervisory authorities in defining and working on the state of the bank audit.

For harmonisation of statutory audit requirements is adopted a public oversight for statutory auditors and audit firms on the basis of home country control (Directive 2006/43/EC). Each Member State has competent authority in charge for approving statutory auditors and audit firms.

In different legislations differs the definitions of auditor independence, incl. the time limit for auditor rotation (Financial Stability Board, 2017). In most cases, the control function for auditor independence is in the hands of the audit committees, but in some cases it falls to the supervisory authorities. Similarly, the authorities who propose to the general meeting of shareholders the choice of an external auditor are different: on the recommendation of the audit committee or of the supervisory authority.

3.7. Supervision of rating companies

Credit rating agencies are one of the key players in promoting good corporate governance practices. Their involvement consists in reviewing and assessing the impact of corporate governance on the risk profile of the banking group (Basel Committee on Banking Supervision, 2010).

Rating agencies failed to offer safe and free ratings for financial products (Organization for Economic Co-operation and Development, 2009). To reduce dependence on credit rating companies, an international practice has been introduced by the G20 and the Financial Stability Board. Therefore, banks should be encouraged to prefer the use of an internal rating instead of an external credit rating even for the purpose of calculating capital requirements.

In the euro area, the supervision of credit rating agencies is entrusted to the European Securities and Markets Authority (Regulation 462/2013). Since the beginning of 2018, 45 rating companies have been registered operating in the EU.

Conclusions and recommendations

The new reality defines new functions of banking supervision. They go beyond traditional framework and embrace corporate governance practices. The justification for expanding the scope of supervision is a response to the complexity of banking structures and innovative services. The ultimate goal of the new banking supervision framework is to prevent future crises and stakeholders to meet the costs.

Our results partially support the first hypothesis (*H1*) – the banking supervision is adapted to changes in bank structure and services. To increase the competitiveness and profitability of banks, national policies have been adopted to stimulate banking activities in other countries and sectors. Simultaneously with the positive financial results of the banks, negative effects related to the stability of the national economy are reported. The degree of coordination of supervisors has led to the transfer of overseas problems and the reporting of spill-over effects of measures to tackle the global financial crisis. The hypothesis and its comments related to banking supervision in the home country only. For completeness of our results, we recommend carrying out a further analysis of banking supervision dynamics in a host country which banking system is dominated by foreign ownership, for example Bulgaria.

The study data indicate an extend scope of banking supervision. An essential element supporting the second hypothesis (*H2*) is increasing of number of supervisors as well as extension of their scope. The classic view of the scope of banking supervision only to meeting financial ratios is one of the sources of the global financial crisis. Practice has shown that such supervision, limited to financial dimension only, encourages banks to innovate in other dimensions beyond the scope of supervision. The new reality established a new generation of banking supervision focused on non-financial dimension, incl. the corporate governance practices.

In addition to adhering to financial performance, we add compliance with good practices in corporate governance. On the second place remains the main function of the banks - to credit the economy.

Every regulation leads to innovation - finding a balance between positive financial results and good corporate governance practices. We can presume the next topic for discussion will be compliance with supervisory requirements combined with responding to social expectations of economic growth, wealth maximization and job creation. The expanding scope of banking supervision shifts good corporate governance practices from the research sector to banking supervision. Unlike financial results, good corporate governance practices transformed from recommended to mandatory.

Extending the scope of banking supervision to non-financial dimension raises issues that are qualitatively new to the economists. The lack of time to implement the extended supervisory scope has an impact on increasing compliance costs. A new sector is emerging, or rather, a new profession, related to the interpretation and application of the new supervisory framework.

The next step in extended banking supervision is the adaptation of national regulations to EU directives and international recommendations. The ultimate effect is expected to restore confidence both to banking groups and to banking supervision. Overcoming the shortage of trust in the banking system will be an embodiment of the new form of social license. We can be argued that the new culture of supervision of non-financial information will change the rest economic pillars.

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